No. 11,626

In the United States Circuit Court of Appeals for the Ninth Circuit

LILY HO QUON AND ALBERT T. QUON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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CITATIONS

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OPINION BELOW

The only opinion in this case is the unreported memorandum findings of fact and opinion of the Tax Court entered March 28, 1947. (R. 31–40.)

JURISDICTION

This is an appeal by Albert T. Quon and his wife, Lily Ho Quon, both residents of the State of California, from separate decisions of the Tax Court of the United States redetermining a deficiency in federal income tax against each petitioner for the year 1941 in the sum of $9,835.08. (R. 31, 40, 41.)

The taxpayer and his wife filed separate income tax returns for the year 1941 with the Collector of Internal Revenue for the sixth district of California at

Los Angeles on a community property basis. (R. 31.) Under date of May 27, 1944, the Commissioner of Internal Revenue, pursuant to Section 272 (a) of the Internal Revenue Code, mailed statutory notices to the petitioners proposing to assess against each a deficiency for the year 1941 in the sum of $9,835.08. (R. 11–15.)[1] Within the time allowed therefor, the taxpayers petitioned the Tax Court for redetermination of the deficiencies asserted against them. (R. 2, 4, 7–11.) The Commissioner duly answered (R. 2, 4, 30–31), and the Tax Court, after hearing in due course (R. 2–3, 5), entered its decision on March 31, 1947, affirming the determination of the Commissioner (R. 40, 41). The proceeding is brought to this court by a joint petition for review filed with the Clerk of the Tax Court on April 14, 1947 (R. 42–46), pursuant to Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether under the facts found by the Tax Court the petitioners, husband and wife residing in the State of California, are taxable proportionately under Section 22 (a) of the Internal Revenue Code upon the distributive share of partnership income distributable to the trustees of four separate trusts set up by the petitioners, as grantors, for the benefit of their four

[1] The cases were consolidated for hearing before the Tax Court. (R. 2–3, 5, 31.) They are before this Court on a joint petition for review (R. 42–45) and a consolidated record on review, from which has been omitted such portions of the record before the Tax Court in the case of Mrs. Quon as would represent a duplication of the record in the case of Albert T. Quon, except as to the name of the petitioner (R. 47–48).

minor children, out of one-half of the assets of an alleged family partnership, the business of which previously was conducted as a sole proprietorship.

STATUTES INVOLVED

The statutes involved are set forth in the Appendix, *infra.*

STATEMENT

The petitioners are husband and wife residing in Los Angeles, California.[2] The husband, Albert T. Quon, is a resident alien. His wife, Lily Ho Quon, is a citizen. Prior to May, 1941, the husband, as sole proprietor, operated a business under the name of Quon-Quon Company. The business involved importing Chinese decorative merchandise and wholesaling it. (R. 32.)

On May 1, 1941, the taxpayers, as co-trustors, created four separate trusts, one for each of their four children, then ranging in age from ten to four years, respectively. The children are all citizens. Concurrently with the creation of these trusts Quon-Quon Company was reorganized as a partnership, the taxpayers being constituted general partners and the trustees of the four trusts being constituted limited partners. (R. 32.)

Each of the four trusts, to the extent they are material here, are essentially similar except for the identity of the beneficiaries and the trustees. The trust for a daughter, Lillian Mae, born August 1, 1932,

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[2] The husband, Albert T. Quon, is sometimes referred to herein as the taxpayer, while both are sometimes referred to jointly as the taxpayers.

may be considered as typical of all of the trusts.[3] This trust indenture (R. 15–22) recites that Albert T. Quon "owns and operates" Quon-Quon Company, which business was community or joint property of the taxpayers, and that they desired to make provision and settlement for their daughter by irrevocable transfer, in trust, of an interest in such business (R. 15). The taxpayers, as co-trustors, thereupon assigned to Lillian Mae's trustee an undivided 12½ percent interest in the business of Quon-Quon Company, subject to the terms of the partnership hereafter described. The trust instrument provides that (R. 16):

> 1. Concurrently with the execution of this indenture, said business shall be reorganized as a limited partnership and Trustee shall become a limited partner therein. As such limited partner and as Trustee under this Trust Agreement, he shall have a twelve and one-half percent (12½%) interest in said business and shall be entitled to receive twelve and one-half percent (12½%) of the net profits thereform and said share of the profits shall be credited to the Trustee and distributed to him from time to time, pro rata with distribution to the general partners in said business.
>
> 2. Trustors shall be general partners in said limited partnership. Said limited partnership

[3] The Tax Court referred to the pertinent provisions of the trust for their son, Ronald, as typical of the material provisions of all of the trusts. (R. 32–35.) The corresponding provisions of the trust for Lillian Mae are referred to herein as being typical because it is printed in the record (pp. 15–22) as an exhibit attached to the petition filed with the Tax Court in the case of Albert T. Quon.

> shall continue for twenty-five (25) years unless sooner terminated by the death, withdrawal or transfer of interest of one of the general or limited partners.

Under the indenture the trustee is vested with power (R. 17):

> a. Upon termination, dissolution or reorganization of said limited partnership, to reinvest his distributive share of the proceeds therefrom, or any part thereof, in the capital assets or capital stock of any partnership, corporation or other company which may be organized for the purpose of acquiring the assets and continuing the operation of said business.

Under the indenture the trustee is further authorized to sell or exchange trust assets, purchase other assets, invest trust funds or borrow money and obligate or encumber the trust estate therefor, but all only with the written consent of the beneficiary after she attains 21 years of age, or only with the written consent of the parents or legal guardian of the beneficiary prior to that time. (R. 17.)

The trust instrument further provides that when the beneficiary, Lillian Mae, reaches the age of 21 years, the trustee shall thereafter pay her from the income or principal, or both, of the trust estate such amount as in the trustee's discretion is necessary to maintain the standard of living to which she has been theretofore accustomed, if her parents or surviving parent is not ready, willing, and able to provide such funds for her. (R. 18.)

The trust instrument further provides that when the beneficiary reaches the ages of 21, 25 and 30 years the

trustee shall pay her, respectively, one-fourth, one-third, and one-half of the then accumulated income and principal of the trust estate other than the partnership interest in Quon-Quon Company. When she reaches the age of 35 years the trustees are to pay her the entire remainder of the estate and the trust will terminate. If she should die before attaining the age of 21 years, the trust estate is to go to her issue or, if none, equally to the remaining trusts. If she dies after reaching the age of 21 years, the trust estate is to go to her heirs, devisees, or legatees. (R. 18–19.)

Finally, the trustee is entitled to compensation for ordinary and usual services in the amount of $50 per year and such additional compensation for extraordinary services as a court of competent jurisdiction may award. If the trustee is to be absent from the State of California for an extended period of time, a co-trustee may be appointed by a court of competent jurisdiction to act during such period of absence. If the trustee resigns, a successor trustee must be appointed by a court of competent jurisdiction. (R. 20–21.)

Concurrently with the creation of the above trusts, Quon-Quon Company was reorganized into a purported partnership. The taxpayers were general partners, each having a 25 percent interest, and the four trustees of the four trusts were limited partners, each having a 12½ percent interest in the partnership. Each general partner contributed to the partnership an undivided 25 percent interest in the business of Quon-Quon Company. Each limited partner contributed to the partnership an undivided 12½

percent interest in the partnership business, each such $12\frac{1}{2}$ percent interest being valued at $11,268.06. (R. 35.)

The alleged partnership is for a term of 25 years. It can be dissolved by the death of a general or limited partner, the transfer or attempted transfer of the interest of any general or limited partner, the retirement or withdrawal from the partnership of any general or limited partner. The substitution of a successor trustee as a limited partner does not operate to dissolve the partnership. (R. 35.)

Among other things, the so-called partnership agreement provides (R. 26–27, 35–36):

> VII.
>
> Each limited partner and each of the general partners has agreed and does hereby agree to contribute to the partnership capital a pro rata amount, based on his or her respective interest in said partnership assets and profits, only out of his or her share of the net profits from said business, sufficient in the aggregate to pay all obligations of said business heretofore or hereafter incurred and to provide adequate working capital.
>
> VIII.
>
> No definite time has been agreed upon for the return of the contributions of the limited partners. Their pro rata shares of the capital assets of the partnership shall be returned to them, concurrently and pro rata with distribution to the general partners, upon termination of the partnership and liquidation of its assets.

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As early as 1939 the taxpayer discussed the advisability of creating trusts for his children but nothing was then done. In 1940 he went to China to purchase merchandise for the business and was absent from this country approximately from April to August, inclusive. During this period an employee named Fung was in control of the business and operated it. After the taxpayer returned from China in August 1940, he became concerned over the possibility that his business assets might be frozen by executive order since certain alien property in this country was becoming subject to such controls. Early in 1941 the taxpayer discussed the problem with various friends and advisors. The plan to create the trusts and the partnership, which was executed May 1, 1941, grew out of these discussions and was prompted by various considerations. One consideration was the taxpayer's parental desire to make provision for the security of his children. Another consideration was the fear of having the assets of his business frozen by the Government, and since his children and wife were citizens partial ownership of the business assets by them was considered a practical method of avoiding seizure to that extent. Another consideration was the reduction of taxes. (R. 36–37.)

After creation of the so-called partnership, the business of Quon-Quon Company continued to be conducted in all material respects in the same manner as it had been conducted prior to the partnership. The limited partners played no part in the conduct of the business. Capital and drawing accounts were set up on the partnership books for each limited partner.

To each limited partner's capital account was credited $12\frac{1}{2}$ percent of the partnership's net profit. Checks were drawn from time to time by the taxpayer on the partnership's commercial account, payable to various banks and brokers, which checks were ratably charged against the limited partners' drawing account. These checks were drawn to purchase securities which were delivered by the taxpayer to the trustees. Later the trustees themselves directly purchased securities for the trusts from the amounts credited to them on the partnership books. These purchases were approved by the taxpayers as parents of the beneficiaries. (R. 37.)

On the taxpayers' income tax returns for 1941 the income of Quon-Quon Company from January 1, 1941, to April 30, 1941, inclusive—the period prior to formation of the so-called partnership—was shown in the amount of \$40,580.19, which amount included the husband's salary of \$4,000 from the partnership for the eight month period, May to December, inclusive. This amount was also reported on a community property basis. Each trust reported as its share of the partnership income for 1941 the amount of \$9,094.94, or an aggregate amount of \$36,379.76, for the four trusts. In determining the deficiencies here involved the Commissioner added one-half of this latter amount, or \$18,189.88, to the income of each of the taxpayers. (R. 37–38). In explaining his determination the Commissioner stated (R. 13–14, 38):

> Income reported in the aggregate amount of \$36,379.76 in the fiduciary returns filed for the alleged Ronald Quon, Jeanette Quon, Alberta

Pauline Quon and Lillian Mae Quon trusts, purportedly established for your four minor children by you and your spouse, as so-called co-trustors, is includible in your income to the extent of the $18,189.88 under the provisions of section 22 (a), 166 and 167 of the Internal Revenue Code.

On the basis of the foregoing facts the Tax Court affirmed the determination of the Commissioner (R. 38–41), and the taxpayers have petitioned this Court for a review of the decisions of the Tax Court. (R. 42–45.)

SUMMARY OF ARGUMENT

Partnerships are not separately taxable for federal income tax purposes. Instead, the members thereof are taxable in their individual capacity upon their distributive share of the partnership income, whether distributed or not. However, a mere written agreement among members of a family which has as its principal objective or accomplishment the division of family income for purposes of reducing taxes is not a valid partnership for federal income tax purposes. Such a partnership must have a genuine business purpose. The act of transferring to other members of the family, as here, by trust or otherwise, a substantial interest in a business theretofore conducted as a sole proprietorship, merely to protect the assets from possible seizure by the Government, does not constitute a valid business partnership for income tax purposes. The fact that such interest was transferred to trustees under irrevocable trusts for the benefit of minor children is immaterial.

Whether a so-called family partnership is a valid partnership for income tax purposes is a question of fact to be determined from the evidence. Here the Tax Court has found that no valid partnership exists under the facts, and that finding is supported by the evidence. It is binding upon this Court.

ARGUMENT

The Tax Court did not err in holding under the facts that taxpayers are liable for tax upon that part of the income of Quon-Quon Company distributable or distributed to the trusts created for their minor children

The only question involved in this case is whether the Tax Court, under the facts set out above, correctly sustained the Commissioner's determination that income of Quon-Quon Company for the year 1941 in the sum of $36,379.76, which had been reported in equal shares as income of the four trusts created by them on May 1, 1941, for the benefit of their four minor children, was taxable one-half to each of the taxpayers. We submit this question is fully answered by the recent decision of the Supreme Court in *Commissioner* v. *Tower,* 327 U. S. 280, and *Lusthaus* v. *Commissioner,* 327 U. S. 293, as well as by numerous decisions by the several Circuit Courts of Appeals, dealing principally with the status of so-called family partnerships for federal income tax purposes, and by other recent decisions of the Supreme Court, including *Dobson* v. *Commissioner,* 320 U. S. 489, rehearing denied 321 U. S. 231, *Commissioner* v. *Scottish American Co.,* 323 U. S. 119, and *John Kelley Co.* v. *Commissioner,* 326 U. S. 521, dealing principally

with the authority of the appellate federal courts to review decisions of the Tax Court.

In this case the Commissioner added the income in question to the income reported by the taxpayers with the explanation that the income was includible in their returns under the provisions of Sections 22 (a), 166 and 167 of the Internal Revenue Code (Appendix, *infra*). (R. 13–14, 38.) In its opinion (R. 38–40), the Tax Court held the income taxable to the taxpayers under Section 22 (a) of the Internal Revenue Code, and did not pass upon the question of taxability under Sections 166 and 167.[4]

The taxpayers argue generally that the *Tower* and *Lusthaus* cases, *supra,* are distinguishable on their facts from the instant case (Br. 8–13), and that the decision here should be controlled by the decisions of the Circuit Court of Appeals for the First Circuit in *United States* v *Morss,* 159 F. 2d 142, and of the Circuit Court of Appeals for the Fifth Circuit in *Thomas* v. *Feldman,* 158 F. 2d 488 (Br. 13–14). We submit there is no merit to either proposition.

In view of the decisions of the Supreme Court in *Commissioner* v. *Tower, supra,* and *Lusthaus* v. *Com-*

[4] The Tax Court did not pass upon taxability of the income in question to the taxpayers under Section 22 (a) of the Code as construed and applied in *Helvering* v. *Clifford*, 309 U. S. 331. Under the circumstances, if the Court should be of the opinion that the alleged partnership here involved is a valid partnership for federal income tax purposes, it probably will want to remand the case to the Tax Court for determination of these pretermitted questions. Compare *Hopkins* v. *Commissioner*, 144 F. 2d 683 (C. C. A. 6th), on remand, *Hopkins* v. *Commissioner*, 5 T. C. 803, affirmed, 157 F. 2d 679 (C. C. A. 6th), certiorari denied, June 2, 1947. But see *Jones* v. *Norris*, 122 F. 2d 6 (C. C. A. 10th).

missioner, supra, and the myriad of other decisions by this Court and other federal courts, both before and since these Supreme Court decisions, dealing with abortive tax saving arrangements of this character,[5] it would be an imposition upon this Court to discuss at length the fundamentals of partnership law or the history or principles of taxation of partnerships under the federal income tax statutes.[6] Partnerships are not taxable as such for federal income tax purposes. Section 181 of the Internal Revenue Code (Appendix, *infra*). Instead, the individual members are taxable upon their distributive share of the partnership income, whether distributed or not. Section 182 of the Internal Revenue Code (Appendix, *infra*). However, the provisions of income tax statutes apply only to bona fide partnerships which have a genuine business purpose and the

[5] See notes 1 and 2 of *Commissioner* v. *Tower*, *supra*, p. 280. The principles upon which the decisions in the *Tower* and *Lusthaus* cases, *supra*, are based are not limited to so-called family partnerships. They apply to cases involving the relationship of a sole stockholder to his corporation. While the relations between a corporation and its sole stockholder may not, for the reason that the stock is solely owned, be disregarded for tax purposes, transactions between them must, to be effective for tax purposes, have reality; must not be mere tax dodging devices without substance or business benefits. *Gregory* v. *Helvering*, 293 U. S. 465; *Griffiths* v. *Commissioner*, 308 U. S. 355; *Higgins* v. *Smith*, 308 U. S. 473. Nor can such a result be accomplished by the creation of a trust, the principal effect of which is a mere reallocation of the family income. *Helvering* v. *Clifford*, 309 U. S. 331.

[6] The history of the provisions dealing with taxation of partnerships for federal income tax purposes is discussed at some length in *Neuberger* v. *Commissioner*, 311 U. S. 83; *Commissioner* v. *Lamont*, 156 F. 2d 800 (C. C. A. 2d); and *Craik* v. *United States*, 31 F. Supp. 132 (C. Cls.).

mere signing of a written agreement by members of a family, or, as here, by the parents and trustees representing trust estates created by the parents under the circumstances of this case for the benefit of their minor children, which has as its most apparent objective the division of family income, will not create a bona fide partnership for federal income tax purposes. As the Supreme Court said in *Commissioner* v. *Tower, supra,* pp. 286–287:[7]

> A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses. When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both. And their intention in this respect is a question of fact, to be determined from testimony disclosed by their "agreement, considered as a whole, and by their conduct in execution of its provisions." *Drennen* v. *London Assurance Co.,* 113 U. S. 51, 56; *Cox* v. *Hickman,* 8 H. L. Cas. 268. * * *

The Supreme Court then pointed out (p. 287) that there is no reason why this general rule should not apply in tax cases where the Government challenges the existence of a partnership for tax purposes. And

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[7] See, also, *Meehan* v. *Valentine*, 145 U. S. 611, 618; *Cohan* v. *Commissioner*, 39 F. 2d 540 (C. C. A. 2d).

where, as here, the Tax Court, acting pursuant to its authority, has found from the evidence before it that the parties to the agreement did not intend to carry on business as a partnership, and this finding is supported by the evidence, it is final. *Dobson* v. *Commissioner, supra.* Furthermore, when the alleged partnership arrangement is among members of a family it is subject to particularly careful scrutiny. *Commissioner* v. *Tower, supra; Lusthaus* v. *Commissioner, supra.*

That the taxpayers and the parties designated as trustees of the trusts for the benefit of their four minor children did not really and truly intend to join together for the purpose of carrying on business is eminently clear from the terms of the partnership agreement (R. 22–28), the terms of the several trust agreements (R. 15–21), and from the facts found by the Tax Court (R. 32–38), none of which are controverted by the taxpayers. Prior to May 1, 1941, the business of Quon-Quon Company had been conducted by Albert T. Quon as a sole proprietorship. After that there was no change in the conduct of the business. No new capital was added which had originated with the new partners. No new services were performed for the business by any of the partners. The limited partners played no part in the conduct of the business.

The Tax Court found (R. 36–37) that the creation of the trusts for the benefit of the taxpayers' minor children, and the formation of the so-called partnership, was prompted by several considerations, none of which involved a genuine business purpose such as

would satisfy the requirements of the income tax statutes. One consideration was the desire of Albert T. Quon to make provision for the security of his children. Another consideration was his fear of having the business assets of Quon-Quon Company frozen by the Government because he was an alien, and it was thought that partial ownership of the business assets by his wife and children, who were citizens, provided a practical method of avoiding seizure to such extent. Another consideration was the reduction of taxes. (R. 36–37.)

As pointed out by the Tax Court in its opinion (R. 39), the only conceivable element in this case which possibly could be considered as excepting this case from the familiar family partnership pattern is the husband's claimed business purpose in making the trust and partnership arrangement to avoid the seizure of his business assets. The Tax Court properly held that this purpose did not serve to validate the partnership for income tax purposes; that while the desire to avoid the freezing of assets by transferring ownership to citizens is, in one sense, a business purpose, it is not the kind of business purpose (R. 39)—

> which is indicative of the essential intent to really and truly join together for the purpose of carrying on business as partners. The desire to avoid the freezing of assets in fact indicates that the arrangement was intended merely as a technical shifting of title from alien to citizen. The purported limited partners in a sense constituted mere depositories of title for purposes other than those connoting a true partnership.

It should be noted that in adding one-half of the income reported by the several trusts to the income reported by Albert T. Quon and his wife, the Commissioner has not recognized the purported partnership as valid for income tax purposes, even as between husband and wife. The several trust agreements stated that the business of Quon-Quon Company was community property. (R. 15, 32.) In any event, the Commissioner has treated the income of the business as community income for tax purposes, one-half of which is taxable to each,[8] and the taxpayers cannot complain of the Commissioner's action on this score. Furthermore, it is clear from the Tax Court's findings and opinion that the purported partnership is not valid, even as to the husband and wife, for income tax purposes.

This case cannot be distinguished in principle from the decisions of the Circuit Court of Appeals for the Fifth Circuit in *Benson* v. *Commissioner,* 161 F. 2d 821, and *Belcher* v. *Commissioner,* decided July 2, 1947 (1947 P–H, par. 72,504), both of which involve similar family trust-partnership arrangements. In *Scherf* v. *Commissioner,* 161 F. 2d 495 (C. C. A. 5th), each of the two members of a partnership assigned to each of his two children as a gift a part of his interest in the partnership. This is an even stronger case from the taxpayer's standpoint, yet the Circuit Court of Appeals affirmed the decision of the Tax Court, holding that the new arrangement was not a valid partnership for purposes of the income tax.

[8] Compare *Todd* v. *Commissioner*, 153 F. 2d 553 (C. C. A. 9th), now pending before this Court on a second appeal.

See, also, *Haldeman* v. *Commissioner,* 6 T. C. 345; *Pritchard* v. *Commissioner,* 7 T. C. 1128.

The taxpayers seek to distinguish their case from the *Tower* and *Lusthaus* cases, *supra,* on the grounds that (1) in those cases the income involved was the wife's distributive share of the partnership income while here it is the distributive share of the trusts created for the benefit of their minor children over which they, as grantors, have no control (Br. 10–11); (2) in the cited cases the sole purpose of the partnership arrangement was to save taxes while here the primary purpose was protection of the business from destruction by freezing orders (Br. 11–12); (3) in the cited cases the partnership could not be terminated without the consent of the donor, while here any of the trustees, by withdrawing, could terminate the partnership (Br. 12); (4) the donor partner in the cited cases received no salary from the partnership, while here Albert T. Quon was paid a salary for his services which was deducted in arriving at the distributive share of the partners (Br. 12–13); and (5) in the cited cases the distributed shares of the donee partner were not used for a separate benefit while a contrary situation exists here (Br. 13).

These claimed distinctions are without merit.

1. Cases are numerous in which it has been unsuccessfully contended that members of the family other than husband or wife should be taxed as a member of a family partnership. As illustrative, in addition to those cases cited above, see *Wilson* v. *Commissioner,* 161 F. 2d 556 (C. C. A. 4th); *Blalock* v. *Allen,* 151 F.

2d 927 (C. C. A. 5th); *Villere* v. *Commissioner,* 133 F. 2d 905 (C. C. A. 5th); *Tinkoff* v. *Commissioner,* 120 F. 2d 564 (C. C. A. 7th); *Saenger* v. *Commissioner,* 69 F. 2d 631 (C. C. A. 5th); *Cohan* v. *Commissioner,* 39 F. 2d 540 (C. C. A. 2d); *Dawes* v. *Allen,* 61 F. Supp. 284 (M. D. Ga.), affirmed without opinion, 157 F. 2d 518 (C. C. A. 5th); *Lang* v. *Commissioner,* 7 T. C. 6; *Harvey* v. *Commissioner,* 6 T. C. 653; *Lawton* v. *Commissioner,* 6 T. C. 1093 (on appeal, Circuit Court of Appeals for the Sixth Circuit).

From the foregoing and numerous other decisions, it is clear that the family relationship is not important.

2. The second alleged distinction already has been answered above. A purpose to prevent disruption or destruction of the business through seizure of the assets of the business by the Government is not the kind of a business purpose essential to the creation of a valid partnership for income tax purposes.

3. The injection of trusts for the benefit of the minor children, as is clear from some of the cases cited above, is not a valid distinction. It is immaterial for federal income tax purposes that the trusts, or the partnerships, or both, may be perfectly valid under state law. Nor is the right of the trusts to share in the partnership income, nor the limitation under state law. Nor is the right of the trusts to tates, determinative of the validity of the partnership for income tax purposes. The arrangement here involved is not recognized as a valid partnership for federal income tax purposes and therefore the income of the business is taxable in the first instance

to the taxpayers. *Lucas* v. *Earl,* 281 U. S. 111; *Poe* v. *Seaborn,* 282 U. S. 101; *United States* v. *Malcolm,* 282 U. S. 792; *Burnet* v. *Leininger,* 285 U. S. 136. In *Scherf* v. *Commissioner, supra,* pp. 497–498, the court pointed out that the *Tower* and *Lusthaus* cases, *supra,* merely apply to situations where the Tax Court has found that individuals are attempting through pseudo-partnerships to separate the earner from income for tax purposes; the rule of the above and other similar cases that the dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid.

4. We fail to see where the fact that Albert T. Quon received a salary from the business which was deducted before computing the distributive shares of the several trusts has any bearing upon the question at issue.[9] The contrary would seem to be true if the parties had joined together for a real business purpose where they would share profits and losses as business associates.

5. From the case just cited it clearly is immaterial what the earner of the income has done with it after he has received it or created the right to receive it. The arrangement here was essentially an assignment of future income, and the conditions imposed upon the donee in the use of that income, or the limitations upon the donor's future control over it, are entirely immaterial to the question involved here.

[9] This salary would be taxable one-half to Albert T. Quon and one-half to the wife. *United States* v. *Malcolm, supra.*

As stated at the beginning of this argument, the two cases relied upon by the taxpayers (Br. 13–14) are not in print. *United States* v. *Morss,* 159 F. 2d 142 (C. C. A. 1st), cited by the taxpayers (Br. 13), involved the question of taxability to the grantor, under Section 22 (a) of the Internal Revenue Code, and the decision in *Helvéring* v. *Clifford,* 309 U. S. 331, of the income of certain trusts which he had created for the benefit of his children. No such question is involved here unless it can be said that the purported partnership in this case is a valid one for income tax purposes. Until the alleged partnership can be established, the instant case involves only the question of taxation of the income of the taxpayer's business to its earner. No income of the trust, as such, is involved unless it can be held that the income of Quon-Quon Company is partnership income. We submit this cannot be done under the facts and the law.

Thomas v. *Feldman,* 158 F. 2d 488 (C. C. A. 5th), though cited by the taxpayers (Br. 13), carries its own distinction from the instant case by concluding (p. 489):

> The distinction between this case and the three cases above mentioned is that here the trier of fact found in favor of the taxpayer and in all the others the facts were against the taxpayer.

For the same reason that case is inapplicable here because here the Tax Court found as a fact that there was no valid partnership including the trust estates created by the taxpayers for the benefit of their minor children. That finding is supported by the evidence and is binding here.

CONCLUSION

The decision of the Tax Court is right. It is supported by the facts and the law and should be affirmed.

Respectfully submitted,

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August 1947.

APPENDIX

INTERNAL REVENUE CODE

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits, any income derived from any source whatever. * * * (26 U. S. C. 1940 ed., Sec. 22.)

SEC. 166. REVOCABLE TRUSTS.

Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—

(1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or

(2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom,

then the income of such part of the trust shall be included in computing the net income of the grantor. (26 U. S. C. 1940 ed., Sec. 166.)

SEC. 167. INCOME FOR BENEFIT OF GRANTOR.

(a) Where any part of the income of a trust—

(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or

(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or

(3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in section 23 (o), relating to the so-called "charitable contribution" deduction);

then such part of the income of the trust shall be included in computing the net income of the grantor.

(b) As used in this section the term "in the discretion of the grantor" means "in the discretion of the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of the part of the income in question."

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(26 U. S. C. 1940 ed., Sec. 167.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U. S. C. 1940 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

(26 U. S. C. 1940 ed., Sec. 182.)

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